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FOR EAP AND EAP/J
STATE PASS USTR FOR CUTLER/BEEMAN
STATE PASS DOJ FOR FOREIGN COMMERCE SECTION: CHEMTOB

E.O. 12958: N/A
TAGS: EINV ECON JA
SUBJECT: BILATERAL INVESTMENT INITIATIVE LOOKS TOWARD FUTURE

¶1. (SBU) Summary: In discussions with U.S. APEC Ambassador Michalak on the future of the U.S.- Japan bilateral investment initiative, GOJ counterparts expressed willingness to expand the initiative's agenda to include a study of investment chapters in FTA and possible exchange between U.S. and Japanese local government officials on how best to promote investment. The next Investment Working Group meeting is likely in late October via DVC. Private sector and GOJ contacts expressed confidence that Japan is on schedule to complete revision of rules allowing triangular mergers before next April. Tax deferral for stock swaps is less certain but business leaders are cautiously optimistic. There has been no progress on tax exemption for Japan branches of U.S universities although Ministry officials told Michalak they are willing to re-open discussions on this subject with Temple University - Japan (TUJ). End Summary

¶2. (SBU) U.S. Senior Official for APEC and co-chair of the U.S. Japan Investment Initiative, Ambassador Michael Michalak visited Japan, September 27 to October 3 to assess progress on several

pending investment issues including mergers and acquisitions (M&A) rules, educational services and labor mobility. In addition, he met the new Japanese co-chair of the bilateral investment working group, Ministry of Economy, Trade and Industry (METI) Director General Tsunehiro Ogawa, to discuss the working group's future program of

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work.

M&A/FDI

¶3. (SBU) Both Japanese and U.S. private sector interlocutors told Ambassador Michalak they were optimistic that revisions to Japan's commercial code allowing mergers using foreign stock as consideration ("triangular mergers") are likely to go into effect as planned in April 2007 without the highly restrictive definitions under consideration last spring. The chairman of the Japan Association of Corporate Executives (Keizai Doyukai) FDI committee said high-profile objections to foreign triangular mergers from some business leaders that had forced a delay in implementing regulations in early 2006 had disappeared. He had "no concerns" that the forthcoming Ministry of Justice draft regulations would be highly restrictive toward foreign mergers. METI's Director for Trade and Investment Facilitation voiced similar optimism. Meanwhile the chair of the American Chamber of Commerce Japan (ACCJ) Foreign Investment Committee was sufficiently sanguine about the outcome that he was already considering advancing new proposals for improving Japan's M&A framework environment, including promoting improved corporate governance by making it easier to file shareholder lawsuits.

¶4. (SBU) The issue of weak corporate governance among Japanese businesses also took center stage in Ambassador Michalak's meeting

with the investment banking team at Nomura Securities that had worked on the recent Oji Paper Corporation takeover bid (TOB) for rival Hokuetsu. The bankers explained in detail how Hokuetsu's last minute defensive measures, most prominently issuance of new stock to a "white knight" investor at a below market price, sunk the bid despite its strong economic advantages. As a result, the interests of corporate insiders and management trumped the opportunity for outside shareholders to obtain top value for their shares by accepting Oji's offer. Nomura's bankers stressed that this highlighted the need for better corporate governance and increased shareholder activism to assure Japanese companies and shareholders achieve the full economic benefit of a growing M&A market. Nonetheless, despite its failure, the bid by an established, mainline Japanese firm had attracted widespread positive media coverage and, Nomura believed, increased public acceptance of M&A as a way to increase corporate value and competitiveness in Japan. They said they would continue to look for other potential M&A transactions that make economic sense and bring positive synergies to the companies involved.

Tax Deferral for Stock Swaps

¶5. (SBU) The outlook for tax deferral for stock swaps was less clear but Keizai Doyukai contacts expressed cautious optimism that the Ministry of Finance (MOF) and the LDP Tax Committee would reach agreement on deferral in time to include it in the FY-2007 budget bill. They were confident that whatever the exact outcome the GOJ would treat foreign and domestic transactions in the same way.

¶6. (SBU) Separately, MOF's International Tax Policy Division Director was noncommittal on the issue but noted "discussions with METI are ongoing." (In a subsequent aside, he intimated that the discussions were contentious.) In part, the reluctance to discuss this issue in detail reflected a desire not to second-guess the ruling party's tax commission deliberation set for November. The commission will conclude their annual deliberations by December, and the new rules, however formulated would begin in May. Ambassador Michalak confirmed that now was the time to present our views to METI on this issue.

¶7. (SBU) MOF was considering a number of related issues with regard to overall tax reform, and noted that deferred tax treatment for foreign shareholding was both highly technical and presented jurisdictional complications. MOF said that the entire issue of tax deferral for stock-compensated mergers was under discussion, regardless of whether it involved domestic or foreign investment. When pressed on the point that domestic and foreign mergers would be treated the same from a tax standpoint, MOF's Director simply said, "Yes." Ambassador Michalak reiterated our ongoing interest in fair tax treatment of triangular mergers, and noted his desire to reach out to both the tax commission and the Japan Business Federation (Keidanren) to reinforce our message.

Tax Breaks for U.S. Universities

¶8. (SBU) Ambassador Michalak made less headway on the issue of tax exemption for U.S. university branch campuses in Japan. ACCJ's International Education Subcommittee briefed the Ambassador on the current state of TUJ's efforts to obtain vocational school status from Tokyo Metropolitan government, an alternative route to tax-free status suggested by the Ministry of Education, Culture, Sports, Science and Technology (MEXT) last spring. As expected, Tokyo turned down TUJ's application since, as a university, it did not meet most of the criteria for a vocational institution. TUJ had recently gone back to the MEXT to discuss other alternatives.

¶9. (SBU) Education was a key issue for both Keizai Doyukai and the Chairman of the Japan Investment Council Expert Committee. Both described for Ambassador Michalak the need for greater flexibility and openness in Japan's educational system and a demand by Japanese businesses for more locally trained MBAs and greater foreign language capable graduates. ACCJ Sub-committee members welcomed the opportunity to showcase how they could help Japan address growing demographic challenges by promoting the idea of continuing education in contrast to an educational establishment that still saw formal tertiary education as something focused on the 18-22 year-old

cohort. After hearing Ambassador Michalak's description of his discussions with Keizai Doyukai, ACCJ members expressed interest in meeting with that organization to address these issues.

¶10. (SBU) Meanwhile, the newly appointed MEXT Director General for Higher Education signaled his bureau's flexibility in resolving the tax issue. Ambassador Michalak noted the continued USG interest in this issue and the important "value-added" that foreign universities provide both to Japanese students seeking educational alternatives and Japanese employers seeking more globalized workers. Michalak thanked MEXT for agreeing to meet again with TUJ to seek a solution and said he looked forward to hearing the outcome of those discussions.

Labor Issues

¶11. (SBU) A number of Japanese interlocutors welcomed Ambassador Michalak's idea of trying to structure our discussion on labor mobility issues (pension portability, layoff compensation, management flexibility) in the working group in such a way as to support Prime Minister Abe's stated interest in providing a "second-chance" to workers and businessmen disadvantaged by economic reform (the so-called "sai-challenge" issue.) The Japan Investment Council's Expert Committee Chair told Michalak that Japan faced growing problems in its labor market and labor policies in the coming years. Japan's labor force, he said, is under increasing "strain" resulting in rising stress levels among workers, declining quality as older baby boom worker retire and are replaced by less well-trained younger workers. Part of the problems stems from the fact that, during the economic recession of the 1990's Japanese sharply cut back their training efforts and support staff. This has resulted in a work force less able to handle high-tech production processes. The result, he said, is a decline in Japan's noted product quality as evidenced by the growing number of product recalls. He has urged the Ministry of Health, Labor and Welfare to take active measure to improve training and labor policies if Japan is to avoid serious economic consequences in the next few years.

Future Program of Work

¶12. (SBU) Ambassador Michalak met the new Initiative co-chair, METI Director General Tsunehiro Ogawa, to discuss the Initiative's future program of work and reached agreement on having the next investment working group in late October via digital videoconference. Ogawa agreed to a U.S. request to keep the existing issues of M&A/triangular mergers, education and labor mobility on the agenda and to add discussion on a future program of work. Ogawa promised a quick answer to our request for Japan's specific agenda items. (Subsequently, METI confirmed that it would also keep its existing issues on the agenda - visas, Exon-Florio and cargo security.)

¶13. (SBU) In a general discussion of what might be included in a future program of work the two chairs expressed interest in undertaking a review of existing investment chapters in U.S. and Japan free trade agreements with a view to identifying what might be included in a future "gold standard" investment text. However, METI preferred not to explicitly link such a discussion to a possible future US-Japan FTA (the "building block" approach) fearing a backlash among more protectionist elements in the GOJ. Rather, METI would like to use the outcome of this process to encourage regional integration and higher standards in investment chapters in future FTA negotiations. METI officials admit ruefully that Japan has failed to get strong investment language in several recently concluded FTAs. METI's Ogawa also suggested the bilateral investment discussions could draw upon the Japan-led work on model investment guidelines already underway in APEC.

¶14. (SBU) Ambassador Michalak also tabled two other possible new issues drawing on suggestions from business contacts. First, he raised the possibility of using the working group to support exchanges between state-level investment promotion offices and Japanese prefectural officials so both sides can share "best practices" in this area. METI strongly welcomed the idea as it tracks ideas they already had under consideration. A number of business contacts, most notably Keizai Doyukai have lamented the ineffectiveness of many Japanese regional governments in promoting

economic growth and investment when compared with U.S. state-level successes. Ogawa and Michalak agreed to discuss this idea in greater detail at the DVC.

¶15. (SBU) METI also welcomed Ambassador Michalak's idea of inviting the Industrial Revitalization Corporation of Japan to a future working group meeting to brief on "lessons learned" in its efforts to promote corporate restructuring. Another possibility is a briefing by Keizai Doyukai on ways to encourage investment funds to be effective "change agents" in improving Japanese corporate governance and creating a more welcoming M&A environment.

"Invest Japan" Investment Seminar

¶16. (U) During his visit, Ambassador Michalak took time to travel to Sendai to address the first of two back-to back "Invest Japan" business seminars co-sponsored by JETRO and the U.S. Embassy. The seminars, aimed at increasing foreign investment in Japan's regions, brought together ten small and medium- sized U.S. companies in emerging fields of mobile telephony and communication, industrial quality control, Voice over Internet Protocol, software design, network security and alternative energy with potential Japanese partners. One U.S. private sector participant commented after the program they found it to be a "very fruitful, well coordinated and professionally executed trade mission."

¶17. (U) Ambassador Michalak has cleared this message.

SCHIEFFER